with an income tax. The top rate is 6.8% in New York, 5.6% in Massachusetts, and about 10% in Rhode Island.

Second, since the state income tax is deductible on the federal return, this lowers the bite from 4.5% to more like 2.7% for those in the top federal bracket. The deductibility of state income taxes allows Connecticut residents to export hundreds of millions of dollars of the state income tax burden to the rest of the country.

Third, before our broad-based income tax was introduced, most high rollers were already paying the tax on interest, dividends, and capital gains at rates that reached 14%, the highest in the nation by far. Some got a tax cut when the broad-based income tax was adopted.

And fourth, many filers who worked in bordering states paid less when the income tax was introduced. Here's why. A Greenwich economist working in New York pays income taxes to New York on her earnings there, then gets a credit for that payment against her Connecticut return, thus erasing her Connecticut liability on that income. She still pays Connecticut taxes on other income—but at a 4.5% rate instead of 14%.

This last point works to Connecticut's advantage for those working in Connecticut but living elsewhere. Before Connecticut's income tax, this group paid income taxes to their state of residence (except for New Hampshire). They now pay taxes here and get credit on their home state return, with no change in their overall burden. Connecticut collects over $300 million a year from non-residents or part-year residents. Most of this money was simply paid to other states when Connecticut had no broad-based income tax.

In light of the above, the General Assembly may be tempted to close the projected budget gaps by simply raising the top rate on high-income filers. But that's dicey. When Connecticut adopted a broad-based income tax, it lost its unique status, especially with chief executives who get to choose where to locate corporate facilities. We minimized the damage by keeping the tax rate relatively low, but it wouldn't take much to lose that small advantage. For example, just a one-percentage point increase would virtually match the rate in Massachusetts.

And the new tax has broader implications for the economy. For example, it may have stalled our economic recovery during the 1990s and slowed our population growth to only 3.6%, fourth slowest nationally. Population in the seven states without an income tax grew an average of 22.9% between 1990 and 2000, double the 11.4% average for states with an income tax. We should be careful about inferring causality from this, since differences in demographics, living costs, climate, and the like also shape population patterns. Still, we should think twice before raising the top income tax rate.

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Same Old, Same Old… But With A Difference?

By Art Wright

The economy is once again in recession, and gold has again turned to dross in the State's budget. The surpluses that funded tax rebates just a short time ago have morphed into deficits that seem to swell with each passing week. Like clockwork, deficit politicking is in full swing. Republicans and Democrats disagree over how big the deficit will be, and also over how to cope with it—cut spending, raise taxes, issue new debt, or dip into State budget reserves?

The Capitol sausage machine is working as usual, but the problems seem less severe than the last time. Then, State politicos exhausted budget reserves in fiscal years 1988-1991 before biting the bullet and passing the current income tax, which took effect in September 1991. (See William A. McEachern's article on the facing page.) This time, the recession's effects seem to have been milder, and going into the downturn the State's Rainy Day Fund was full at its target 5% of spending. Recent State surpluses were used to fund capital projects and one-time outlays as well as to retire debt.

The Governor and the General Assembly deserve pretty good marks for their husbandry of Connecticut's fiscal resources over the past decade. Our elected officials have largely resisted the temptation to match strong revenue growth with new spending. How to use surpluses, the Rainy Day Fund, and new debt—to stabilize spending, fund capital projects, or start new programs—is still the stuff of political debate. But that is inevitable, and right.

Longer term, though, some see the pink if not rosy budget picture fading if certain structural problems in state finances prove tougher than now anticipated.

Dimensions of the Current Deficit

The general-fund budget for FY 2002 that the General Assembly passed in June 2001 was in balance at $11.9 billion in revenues and appropriations. (The *total* budget also includes more than a billion dollars in "special appropriations," 80% of it "Special Transportation Funds.") By the end of last year, a gap of more than $550 million had opened up in that budget. Several rounds of spending cuts and other maneuvers beginning in September brought the projected deficit down to $165 million as of this writing. For comparison, the Rainy Day Fund stood at about $600 million in July 2001, according to estimates in Governor Rowland's proposed FY 2002 budget, completed in February 2001.

Budget pains in the vicinity of 4-5 percent of originally targeted appropriations pale by comparison with the woes of some other states. A December 2001 report by the respected Fiscal Studies Program of the Rockefeller Institute of Government at SUNY-Albany put Connecticut near the bottom of the heap of troubles. Measuring projected FY 2002 budget shortfalls as a percentage of FY 2000 expenditures, the study found Alaska (with a double whammy from lower oil prices on top of the recession) at the top at 28.3%, trailed by Minnesota at 17.0%, and Arizona at 11.2%. In New England, Maine was in Connecticut's league, while Rhode Island, Vermont, and Massachusetts were in the next higher tier. (New Hampshire was not part of the analysis.)

Grounds for optimism? Smugness may be premature, given (a) the trend in the State's deficit since last summer; (b) the underestimate by the Rockefeller Institute of the size of Connecticut's FY 2002 shortfall ($96 million); and (c) warnings (*e.g.*, by Economy.com, the regional/national forecasters) that New England, late to the recession, may not have seen the worst of it yet (*Wall Street Journal*, "Regional Report," January 23, 2002, p. B12).

The usual suspects underlie Connecticut's current budget difficulties. The economic slowdown, prudently assumed in advance for the FY 2002 budget, turned into a slump. New appropriations, mostly recession-driven, now total $74.4 million. And tax revenue growth that was expected to tail off, instead went south: at mid-fiscal-year, the Office of Policy and Management (OPM) is projecting that personal income tax revenues will drop by more than $90 million (nearly 2%) from FY 2001, and sales tax collections by more than $35 million (1.1%). Big drops in projected corporation and inheritance-and-estate taxes (respectively, $119.3 and $92.8 million) were largely anticipated, reflecting phased-in cuts or bearish stock markets as well as the recession. Interestingly, tax refunds are expected to jump by $47 million (6.4%) over the FY 2001 level. Real estate conveyance tax receipts are holding their own, reflecting the anomalously strong real estate market, and "Indian gaming payments"—the State's 25% skim from the casinos' "win" on slot machines—are expected to leap by 14.3% to $380 million. Are folks avoiding airline flights and staying closer to home for R&R since 9/11?

So Is It a "Rainy Day"?

Arguably, Governor Rowland and the General Assembly have already donned galoshes and raincoats and put up their bumbershoots, with the $386.2 million in spending cuts and surplus trans-

d. Thus, it is , and so t should dip $600 million Day Fund to the remaining cit of $165 million. To accept that argument requires two assumptions. First, Connecticut's nomy is as bad t's going to get s time around. future gover- l legislatures r they may be) as responsibly se of the past e and restore the Rainy Day Fund to its full 5% of appropriations, once the sun comes out again. That first assumption is suspect, as indicated earlier; hence, our leaders may well have to consider tax increases (*e.g.*, on cigarettes, as Governor Rowland has proposed), further spending cuts, dipping deeper into the Rainy Day Fund, or issuing new debt—that is, simply living with a short-term deficit and borrowing to meet the bills. The more the State relies on budget reserves or borrowing to weather the present storm, of course, the sterner the test facing future officials.

Beyond the Current Deficit

Sound fiscal policy is a strategic, not a tactical matter. Bodies politic seldom achieve sound fiscal policy, because (contrary to conventional wisdom and civics-textbook teachings) elected public officials have time horizons no longer than the next election and often less than that. Connecticut has been fortunate in this regard over the past decade or so, but our political process faces some challenges that demand strategic, not tactical thinking.

One such challenge is the general balance between state and local tax bases, and the particular issue of relative tax burdens between (state) income and sales taxes and (local) property taxes. Taxpayer pressures have led many states, including Connecticut, to curb spending growth, but that may shift responsibility for some social services, especially education, to localities. One way to curb spending growth is to cut state taxes, and Connecticut has been whittling away at its personal income tax, at the low end (with "3% income" and property tax credits), since 1996. Even so, in Connecticut general revenues from state sources as a percent of personal income rose during the 1990s, putting our figure well above the U.S. average (see page 4). The corresponding figure for local revenues did edge up, by only 0.1 point over the decade, but Connecticut was still well below the national average in 1999. Thus, resistance to introducing user fees and other local non-property taxes, combined with reliable state transfers to localities, has prevented a shift of tax burdens from the state to the local level so far.

Three other tax challenges to state governments were the subject of a recent article by Robert Tannenwald, an economist at the Boston Federal Reserve Bank, in its quarterly, *The New England Economic Review* (2001, number 4). Tannenwald warns of the impending "obsolescence" of state revenue systems, because of three often interrelated trends: (1) the shift from goods to services in the nation's mix of output; (2) the proliferation of e-commerce; and (3) the intensification of interjurisdictional tax competition. In all three cases, collaboration among the states may be essential to successfully meeting the challenges.

The growing economic dominance of services has states performing acrobatics to keep their sales taxes broad-based—but at the risk of driving economic activity out-of-state and in the face of opposition to the double taxation of personal services. States that rely heavily on sales taxes still face an uphill battle in use-tax compliance on Internet purchases, or in persuading Congress to levy a national e-commerce sales tax and distribute the proceeds among the states. (The latter would shift the compliance problem to the Federal government.) Prudence may dictate (*e.g.*) shaving another point off the 6% sales tax, to limit the State's exposure.

The "bidding crescendo" (in Alice Rivlin's phrase) in state efforts to attract new investments with tax breaks has reached a point many view as a lose-lose situation. This writer must confess to back-of-the-envelope skepticism that many of the State tax deals announced to lure this plant or that headquarters to Connecticut really benefit the state's economy. Oddly, such deals are hardest to justify during the down-revenue phase of a recession—precisely when new investments could do the most good. Long term, the level and structure of taxes is more important to attracting new investment than one-off special deals.